

STATE OF IOWA
DEPARTMENT OF COMMERCE
UTILITIES BOARD

IN RE: IOWA TELECOMMUNICATIONS SERVICES, INC., d/b/a IOWA TELECOM	DOCKET NO. SPU-04-10
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FINAL DECISION AND ORDER

(Issued July 9, 2004)

PROCEDURAL HISTORY

On April 12, 2004, Iowa Telecommunications Services, d/b/a Iowa Telecom (Iowa Telecom or Company), filed with the Utilities Board (Board) a motion for waiver of the reorganization review requirement pursuant to Iowa Code § 476.77 (2003), or, in the alternative, an application for an expedited review of a proposed reorganization. Also on April 12, 2004, Iowa Telecom filed a proposed reorganization that includes testimony and exhibits addressing each of the statutory criteria outlined in Iowa Code § 476.77.

Iowa Telecom's proposed reorganization involves a recapitalization of the company in the form of a public offering of Income Deposit Securities (IDSs), which are hybrid securities comprised of both debt and equity components. Iowa Telecom states that the public offering will result in a change of ownership of the company's controlling capital stock from four common stockholders to a much broader general investing public. Iowa Telecom states that it expects no significant changes in

management of the company or in its workforce and does not plan to sell, exchange, or otherwise transfer any of its assets in conjunction with the reorganization.

On May 10, 2004, the Consumer Advocate Division of the Department of Justice (Consumer Advocate) filed an objection to Iowa Telecom's motion for waiver of the reorganization review requirement and an answer to the application for expedited review of the proposed reorganization. In its objection, Consumer Advocate states that in the proposed reorganization, Iowa Telecom's existing equity investors will sell a significant portion of their common stock and will hold approximately 20 percent of the common stock after the sale of the IDSs. Consumer Advocate states that the proposed recapitalization will have significant impacts on the long-term capitalization and prospective financial performance of the company and will, therefore, affect Iowa Telecom's customers. Consumer Advocate also states that it is concerned that the proposed recapitalization will have a significant impact on Iowa Telecom's equity ratio, prospective dividends on common stock, and the prospective relationship of dividends and net income, all of which may affect Iowa Telecom's customers.

On May 12, 2004, the Board issued an "Order Docketing for Further Review, Denying Waiver, Granting Request for Confidentiality, and Establishing Procedural Schedule." In its May 12 order, the Board denied Iowa Telecom's request for waiver of the reorganization review requirements and set an expedited procedural schedule to review Iowa Telecom's proposed reorganization so that a final decision could be issued within 90 days as required by Iowa Code § 476.77(2).

On May 18, 2004, Iowa Telecom filed a motion for reconsideration of the Board's May 12, 2004, order. Iowa Telecom requested that the Board reconsider a waiver of the reorganization review requirements or, in the alternative, an acceleration of the expedited procedural schedule. Consumer Advocate filed a resistance to Iowa Telecom's motion on May 21, 2004. On May 28, 2004, the Board denied Iowa Telecom's motion for reconsideration and denied any further acceleration of the procedural schedule.

Pursuant to the procedural schedule established in this docket, Consumer Advocate filed its rebuttal testimony and exhibits on May 26, 2004. Iowa Telecom filed additional rebuttal testimony and exhibits on June 7, 2004.

On June 17, 2004, the Board issued an order requiring Iowa Telecom and Consumer Advocate to prepare an additional exhibit regarding the application of Standard & Poor's (S&P's) bond rating factors shown on Iowa Telecom's Exhibit 13, both with the proposed reorganization and without the proposed reorganization.

A hearing was held in this docket on June 22, 2004, for the purpose of receiving testimony and cross-examination of all testimony and exhibits. Iowa Telecom and Consumer Advocate entered appearances through their counsel.

At the conclusion of the hearing, the Board requested that the parties file simultaneous briefs. Briefs were submitted by Consumer Advocate and Iowa Telecom pursuant to that request.

ISSUES

Iowa Code § 476.76 defines reorganization as including "[t]he purchase or other acquisition or sale or other disposition of the controlling capital stock of any public utility, either directly or indirectly." Iowa Code § 467.76(2) (2003). Prior to any reorganization, a public utility is required to file with the Board a "proposal for reorganization with supporting testimony and evidence to establish that the reorganization is not contrary to the interests of the public utility's ratepayers and the public interest." Iowa Code § 476.77(1). The proposal is deemed approved unless the Board disapproves. Iowa Telecom's proposed reorganization includes a sale of the controlling capital stock of the company, thereby falling within the definition of reorganization as stated in § 476.76(2) and is subject to the Board's review under § 476.77.

Iowa Code § 476.77(3) states that, in reviewing a proposal for reorganization, the Board may consider the following factors:

- a. whether the Board will have reasonable access to books, records, documents, and other information relating to the public utility or any of its affiliates;
- b. whether the public utility's ability to attract capital on reasonable terms, including the maintenance of a reasonable capital structure is impaired;
- c. whether the ability of the public utility to provide safe, reasonable, and adequate service is impaired;
- d. whether ratepayers are detrimentally affected; and,

- e. whether the public interest is detrimentally affected.

This order will reflect the Board's review of the proposed reorganization with respect to each of these factors.

1. Whether the Board will have reasonable access to books, records, documents, and other information relating to Iowa Telecom or any of its affiliates.

Iowa Telecom maintains that its accounting policies and procedures currently comply with the Board's rules and regulations and that the system of accounts will not change as a result of the proposed reorganization. Consumer Advocate does not dispute this issue. Therefore, the Board finds it will continue to have reasonable access to books, records, documents, and other information related to Iowa Telecom after the proposed reorganization.

2. Whether Iowa Telecom's ability to attract capital on reasonable terms, including the maintenance of a reasonable capital structure, is impaired.

Consideration of this factor is intended to determine whether Iowa Telecom's access to capital or its capital structure is or will be impaired by the proposed reorganization.

Iowa Telecom asserts that the reorganization will make the company financially stronger and more flexible, with continued access to debt markets, improved access to equity markets, and a lower overall cost of capital. (Iowa Telecom Brief, pp. 11-15; Transcript, pp. 175-234). Iowa Telecom also claims that the ability to attract capital is not as relevant for a reorganization involving a price-regulated utility as it would be for a rate-of-return utility. (Iowa Telecom Brief, pp. 14-15). As a price-regulated utility, Iowa Telecom states that its capital costs are

not specifically recovered from its customers. Iowa Telecom's rates are tied to inflation and not its cost of providing service.

Consumer Advocate asserts that the proposed reorganization will weaken Iowa Telecom's capital structure and will decrease its financial flexibility and financial strength. (Consumer Advocate Brief, p. 4; Transcript, p. 242). Consumer Advocate states that Iowa Telecom's equity ratio would improve slightly upon the issuance of the IDSs but would decline thereafter and, in a few years, would be worse than it is today. (Consumer Advocate Brief, p. 7; Transcript, pp. 238-39). Consumer Advocate also asserts that neither price regulation nor traditional rate regulation prevents price increases. Additionally, Consumer Advocate claims that Iowa Telecom could seek further price increases pursuant to Iowa Code § 476.97(11)"h," and the Board would be required to consider the impact of a proposed price increase on the ability of the company to attract capital, which, according to Consumer Advocate, would be impaired following the issuance of the IDSs. (Consumer Advocate Brief, p. 6).

The analysis of this factor requires consideration of what is a reasonable capital structure and whether the proposed reorganization diminishes Iowa Telecom's ability to attract capital or increases the Company's cost of capital. Consumer Advocate has demonstrated that a risk exists. However, the Board relies on the exhibits and expert testimony provided by Iowa Telecom that assure the Board that the IDS offering will provide Iowa Telecom the needed access to capital markets as well as greater financial flexibility. (Iowa Telecom Brief, pp. 11-15; Transcript, pp. 175-234). Iowa Telecom provided expert testimony stating that the IDS structure has several features that provide flexibility to allow the Company to deal with

"unforeseen contingencies," such as: 1) excess cash will be distributed to IDS shareholders only after operating costs, interest on senior debt, and capital expenditures are paid; 2) IDS issuers generally do not pay out all excess cash; 3) if necessary, the Board of Directors can cut dividends; and 4) interest payments can be deferred if necessary. (Tr. 180-81). The Board explicitly relies on this testimony in making its decision.

It is not the Board's responsibility to manage the public utilities under its jurisdiction. It may stop a reorganization, but only if it is clear that it is contrary to the interests represented by the statutory factors. Allowing a reorganization to continue does not constitute an affirmative endorsement of the action; it is only a finding that there is not sufficient evidence to disapprove. Iowa Telecom has demonstrated that its Board of Directors will have the authority to balance the needs of the utility company and customers with the desires of its shareholders. Specifically, the ability to cut dividends, if necessary, is important to the Board's analysis of this factor.

Iowa Telecom also asserts that Consumer Advocate places too much significance on the Company's common equity ratio. The Board notes that Iowa Telecom's current and projected capital structure is not typical of the capital structure the Board has previously found to be appropriate for traditional, rate-of-return regulated utility companies. Historically, Iowa Telecom has operated with a lower equity ratio than other utilities. Iowa Telecom witness Collins expressly stated that equity ratios are not as significant in today's financial environment. (Transcript, pp. 161-64). The Board shares Consumer Advocate's concern that the Company's projections supporting the IDS proposal show that equity ratios will, over time, be

reduced even further. However, the Board accepts Iowa Telecom's testimony that these changes will not impede the Company's access to capital.

Under the IDS instrument, the financial market's emphasis appears to be on cash flows rather than common equity. The Board realizes that Iowa Telecom relies on its projections of cash flows in forecasting the success of this offering. Because Iowa Telecom currently operates under price regulation, if the Company's actual results do not meet expectations and its capital costs increase, those costs will not be directly passed on to Iowa Telecom's customers. It is not the Board's present intent to obligate ratepayers to fund the Company should Iowa Telecom request rate relief in part because the projections asserted in this proceeding are not realized. Moreover, the Board does not intend to rescue the Company if Iowa Telecom's ability to attract capital erodes over time as the result of an attempt to maintain the projected dividend payout associated with the marketing of the IDS. While future Boards cannot be bound by this Board's present intent, any future rate proceedings should be reviewed in light of the representations made by Iowa Telecom in this docket.

Based on the representations of the Company regarding its capital structure and its continued access to capital, and in light of the aforementioned concerns, the Board finds that Iowa Telecom's ability to attract capital on reasonable terms and its ability to sustain a reasonable capital structure has not been shown to be impaired by this reorganization.

3. Whether Iowa Telecom's ability to provide safe, reasonable, and adequate service is impaired.

Consideration of this factor is intended to determine whether there will be impairment of Iowa Telecom's ability to provide safe, reasonable, and adequate service following the reorganization.

Iowa Telecom asserts that its service to its customers will continue to be as safe, reasonable, and adequate following the reorganization as it is before the reorganization. Iowa Telecom also states that following the reorganization, there will be no change in executive management of the Company, no operational changes, no impact on access to public safety services, and no impact on its telecommunications network, field customer operations, customer contact operations, or its operational support systems.

Consumer Advocate suggests that as Iowa Telecom's capital structure and financial flexibility and financial strength decrease, the natural consequence will be an adverse effect of the Company's ability to provide safe, reasonable, and adequate service.

Iowa Telecom maintains throughout this proceeding that following the proposed reorganization, the Company intends to continue to meet its obligations of the Settlement Agreement (Agreement) reached in Docket No. RPU-02-4. As part of that Agreement, Iowa Telecom agreed to maintain a pre-determined base line maintenance expenditure and an additional expenditure for network improvements, on an annual basis. The Board understands that these expenditures will have priority over the payment of any dividends to stockholders following the proposed reorganization; that is, the Company will not fail to meet its obligations under the Agreement as a result of paying dividends. Based on this understanding, the Board

finds that the Company's ability to continue to provide safe, reasonable, and adequate service will not be impaired by this reorganization.

4. Whether ratepayers are detrimentally affected

In considering this factor, the Board is required to determine whether Iowa Telecom's customers will be detrimentally affected by the proposed reorganization.

Iowa Telecom asserts that its customers will not be financially affected by the proposed reorganization. Iowa Telecom again refers to its status as a price-regulated company in support of its assertion that its customers will be insulated from any negative impacts of the proposed reorganization because any changes to customers' rates (other than inflationary adjustments) will require prior Board approval.

Consumer Advocate claims that Iowa Telecom could seek additional price increases pursuant to the price regulation statute and the Board would be required to consider, among other factors, the impact of a proposed price increase on the Company's ability to attract capital.

In Iowa Telecom's last rate case, Docket No. RPU-02-4, the Board rejected Iowa Telecom's position that additional revenues improve the company's ability to attract capital and that inquiry under the statute need go no further. In that docket, the Board held that "this factor required consideration of the utility's financial condition, obligations, needs, and prospects to determine if increasing rates will have a significant and beneficial effect on the company's ability to attract additional capital, an effect that is worth the extra cost to customers." In re: Iowa Telecommunications Services, Inc., d/b/a Iowa Telecom, Docket No. RPU-02-4, at p. 30 (issued Dec. 26,

2004). Any future price regulation modification case will include an evaluation of the impact of the transaction currently before the Board on the Company's ability to raise capital.

Iowa Telecom believes this offering will not harm the Company's financial health but, rather, will improve it. As in Docket No. SPU-99-29, the Board has concerns about the proposal, but will rely on Iowa Telecom's assumptions, projections, and exercise of prudent management. Risk is borne by management and shareholders, who stand to gain from the restructuring, and not by ratepayers. As the decision in Docket No. RPU-02-4 demonstrates, the Board has the obligation and the ability to determine if it is reasonable to include certain costs in rates. The representations made by Iowa Telecom throughout this proceeding, in response to Consumer Advocate's arguments on this issue, are sufficient to overcome the evidence indicating that Iowa Telecom's customers will be detrimentally affected by the reorganization. On this record, and giving credit to Iowa Telecom's evidence, we cannot find such an effect.

5. Whether the public interest is detrimentally affected

Iowa Telecom states that the public interest will not be detrimentally affected because the proposed reorganization enables the Company to access the public investment market for capital and in so doing, Iowa Telecom becomes financially stronger, its liquidity improves, and it acquires a more diverse investor base.

Consumer Advocate claims that the only ones who gain from Iowa Telecom's IDS issuance are the existing equity investors.

With respect to the consideration of whether public interest will be harmed by Iowa Telecom's proposed reorganization, the Board finds that the record is clear that the proposed reorganization will benefit Iowa Telecom's initial investors. However, the record also demonstrates that the reorganization will give Iowa Telecom the opportunity to broaden its investment base, which the Board finds is in the public interest.

Nevertheless, the Board finds that it is in the public interest that the Board continue to monitor Iowa Telecom's financial information after this reorganization to ensure the general public interest and the customers' interests are protected. Therefore, the Board will require that Iowa Telecom annually file a detailed annual balance sheet, income statement, statement of cash flows, dividend payments, and copies of any filings submitted to the Securities Exchange Commission (SEC), pursuant to Iowa Code § 476.77(3)"a," for purposes of ensuring that Iowa Telecom's customers specifically, and the public generally, are protected from any undue burden resulting from this reorganization. The SEC filings should be made when they are filed with the SEC; the financial data should be filed annually beginning April 1, 2005.

CONCLUSIONS OF LAW

1. The Board finds that it has jurisdiction over this proceeding pursuant to Iowa Code § 476.77 (2003).

FINDINGS OF FACT

1. Based on the evidence in this record, the Board finds that it will have reasonable access to books, records, documents, and other information relating to Iowa Telecom or any of its affiliates after the proposed reorganization is completed.

2. Based on the evidence in this record, the Board finds that Iowa Telecom's ability to attract capital on reasonable terms, including the maintenance of a reasonable capital structure, will not be impaired by the proposed reorganization.

3. Based on the evidence in this record, the Board finds that Iowa Telecom's ability to provide safe, reasonable, and adequate service will not be impaired by the proposed reorganization.

4. Based on the evidence in this record, the Board finds that ratepayers will not be detrimentally affected by the proposed reorganization.

5. Based on the evidence in this record, the Board finds that the public interest will not be detrimentally affected by the proposed reorganization.

ORDERING CLAUSES

IT IS THEREFORE ORDERED:

1. The "Application for Review of Proposed Reorganization" filed by Iowa Telecommunications Services, Inc., d/b/a Iowa Telecom, on April 12, 2004, is not disapproved as described in this order.

2. Iowa Telecommunications Services, Inc., d/b/a Iowa Telecom, is directed to file annually with the Board a detailed annual balance sheet, income statement, statement of cash flows, and copies any filings submitted to the Securities

Exchange Commission (SEC), pursuant to Iowa Code § 476.77(3)"a." Copies of the filings to the SEC should be made when the original is filed with the SEC. Financial data should be filed annually beginning April 1, 2005.

3. If any assumptions or understandings expressed and relied upon by the Board in the body of this order are incorrect or inconsistent with Iowa Telecom's understanding, Iowa Telecom shall notify the Board of the error inconsistency within 30 days of this order and prior to closing the proposed IDS transaction.

UTILITIES BOARD

/s/ Diane Munns

/s/ Mark O. Lambert

ATTEST:

/s/ Judi K. Cooper
Executive Secretary

/s/ Elliott Smith

Dated at Des Moines, Iowa, this 9th day of July, 2004.